

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:MCT:DET:POSTF-152386-01  
ERSkinner

date:

to: Territory Manager, Manufacturing and Transportation, LM:MT  
Steve Averbuch, Team Manager  
Attn: Jayne Boyle, IE

from: LMSB Counsel, Detroit, Michigan

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subject:

[REDACTED]  
I.R.C. § 302 Distribution in Redemption of Stock

This memorandum is in response to your request for advice regarding the tax treatment of [REDACTED]'s redemption of [REDACTED] [REDACTED]'s stock on [REDACTED].

**Issues**

- I. Whether [REDACTED]'s redemption of [REDACTED] [REDACTED]'s stock in [REDACTED] should be treated as a dividend distribution or a sale/exchange of stock.
- II. What is the gain/loss on the sale of [REDACTED]'s remaining shares of [REDACTED]'s stock in [REDACTED].
- III. Whether the redemption issue in I. above is the same as or substantially similar to the "basis shifting tax shelter" described in Notice 2001-45.

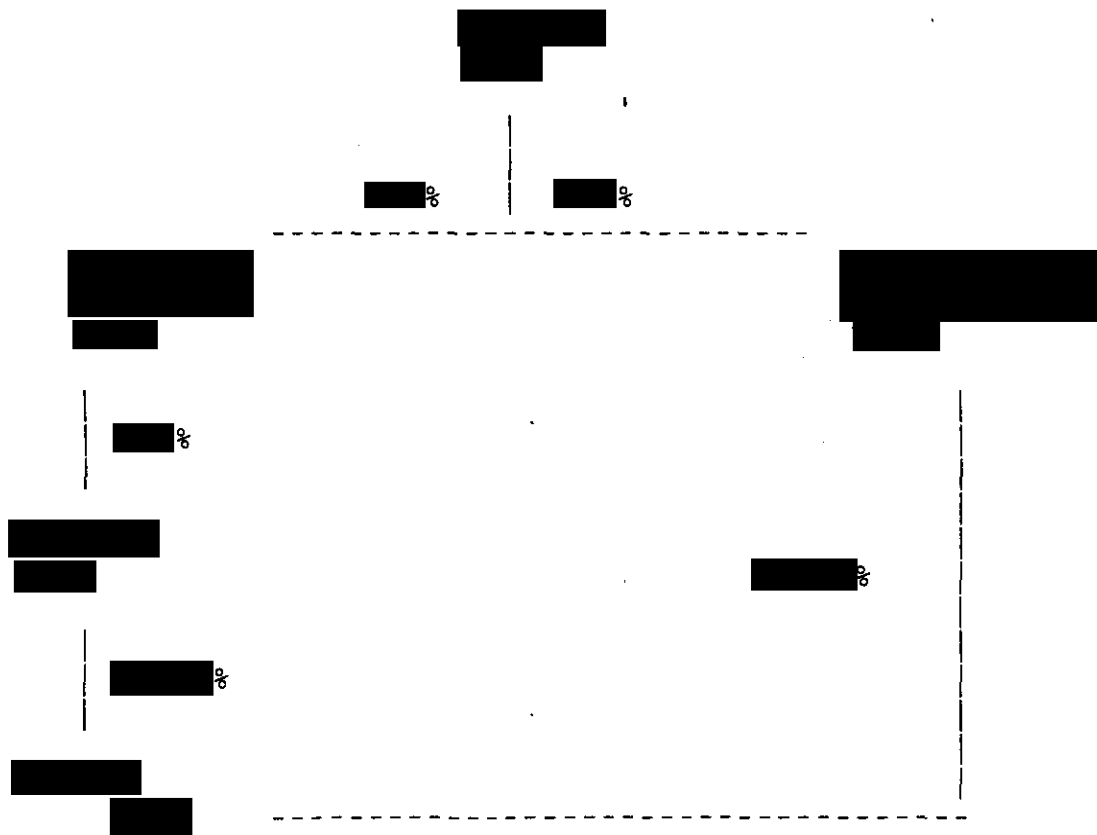
**Conclusions**

- I. [REDACTED]'s redemption of [REDACTED] [REDACTED]'s stock should be treated as a dividend distribution.
- II. The capital loss on the sale of [REDACTED]'s remaining shares of [REDACTED]'s stock in [REDACTED] is \$[REDACTED].
- III. The redemption issue in I. above is not the same as or substantially similar to the "basis shifting tax shelter" described in Notice 2001-45.

**Facts**

[REDACTED], a [REDACTED] corporation ([REDACTED]) and [REDACTED], a [REDACTED] corporation ([REDACTED]) are subsidiaries of [REDACTED]. [REDACTED] and [REDACTED] own shares of [REDACTED], [REDACTED] organized in [REDACTED] ([REDACTED]). On [REDACTED] [REDACTED] owned [REDACTED]% of the economic rights and [REDACTED]% of the voting rights of [REDACTED]'s common stock; the remaining interests were held by [REDACTED].

The corporate relationships as of [REDACTED] were as follows:



On [REDACTED], [REDACTED] agreed to have [REDACTED] of its [REDACTED] shares in [REDACTED] redeemed for cash in the amount of \$ [REDACTED]. The stated business purpose behind the redemption was to place [REDACTED] in a position to lend money to its parent corporation [REDACTED] at a market rate of interest so [REDACTED] could expand its North American interests.

[REDACTED] reported dividends related to the redemption in the amount of \$ [REDACTED] (the earnings and profits of [REDACTED] on the date of the redemption) and a return of capital in the remaining amount of \$ [REDACTED]. Pursuant to Treas. Reg. 1.302-2(c) [REDACTED] adjusted the basis in its remaining shares of [REDACTED] to \$ [REDACTED].<sup>1</sup>

[REDACTED] treated the redemption as a distribution to which I.R.C. § 302(d) applies (dividend treatment). The corporate relationships after the redemption were as follows:




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<sup>1</sup> [REDACTED]'s original cost basis in the shares of [REDACTED] was \$ [REDACTED] (less the return of capital upon the redemption of \$ [REDACTED] equals \$ [REDACTED].)

On [REDACTED], [REDACTED] sold its remaining [REDACTED] shares to [REDACTED] for \$[REDACTED]. [REDACTED] reflected a capital gain (\$[REDACTED]) for book purposes and reflected an M-1 adjustment for a tax capital loss of \$[REDACTED]. [REDACTED] treated the \$[REDACTED] capital loss for tax purposes as deferred until the stock is disposed of outside the consolidated group. (See Ex. A for the computation related to these amounts) The current ownership structure of [REDACTED] is as follows:



### Discussion and Analysis

The term "redemption" is defined by I.R.C. § 317(b) as a corporation's acquisition of its stock from a shareholder in exchange for property whether or not the stock is canceled, retired, or held as treasury stock.

#### Dividend Treatment v. Sale or Exchange Treatment

Under I.R.C. § 302( a), a shareholder treats a corporation's redemption of its stock as a distribution in part or full payment in exchange for the stock (e.g. sale or exchange treatment) if any one of the four conditions specified in I.R.C. § 302( b) is satisfied. The four conditions of I.R.C. § 302(b) are:

302( b)(1) (redemptions not essentially equivalent to dividends);

302( b)(2) (substantially disproportionate redemption of stock);

302( b)(3) (termination of shareholder's interest); and

302( b)(4)( redemption from noncorporate shareholder in partial liquidation).

Section 302 (d) treats a redemption as a distribution of property (dividend treatment) to which section 301 applies if section 302 (a) does not apply. Thus, if a redemption does not satisfy the requirements of any of sections 302( b)(1), 302( b)(2), 302( b)(3), or 302( b)(4), section 302(d) treats the redemption as a distribution of property to which section 301 applies and, to the extent the distribution is out of accumulated or current earnings and profits of the corporation, the distribution is a dividend within the meaning of section 316. In order to determine whether a redemption is treated as a distribution in part or full payment in exchange for stock under section 302( a) or as a distribution of property to which section 301 applies (and thus, potentially, as a dividend under section 316), the four tests under sections 302( b)(1), (2), (3), and (4) must be applied with respect to the owner of the redeemed stock.

Section 318( a) contains rules of constructive stock ownership to be applied to those provisions of subchapter C to which they are expressly made applicable. Section 302(c)(1) provides, with an exception not relevant here<sup>2</sup>, that the constructive ownership rules of section 318( a) apply in determining the ownership of stock for purposes of I.R.C. § 302.

The constructive ownership rule stated in I.R.C. § 318(a)(3)(C) provides that, if a person owns (directly or indirectly) more than 50 percent of the stock of a corporation,

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<sup>2</sup>The exception is for cases involving a complete termination of the shareholder's interest (in this case [REDACTED]'s interest) immediately after the redemption. Since [REDACTED] retained an interest in [REDACTED] immediately after the redemption, the exception does not apply.

such corporation is considered as owning the stock owned (directly or indirectly) by or for such person. This rule and the other constructive ownership rules of I.R.C. § 318(a) are expressly applicable, pursuant to I.R.C. § 302(c)(1), in determining the ownership of stock for purposes of section 302.<sup>3</sup>

*302(b)(1) (redemptions not essentially equivalent to dividends)*

The regulations related to I.R.C. § 302(b)(1) state generally that dividend equivalence "depends upon the facts and circumstances of each case" but do not set forth any specific requirements. See, As an example of redemptions that are generally treated as distributions under I.R.C. § 301, Treas. Reg. § 1.302-2(b) cites pro rata redemptions of a part of the stock of a corporation that has only one class of stock outstanding. Similarly, the regulation indicates that the redemption of all of one class of stock (except section 306 stock) would also generally be considered as a section 301 distribution if all classes of stock are held in the same proportion.

In United States v. Davis, 397 U.S. 301 (1970), the Supreme Court held that the attribution rules of I.R.C. § 318(a) are applicable in determining whether a distribution is "not essentially equivalent to a dividend" under I.R.C. § 302(b)(1) and, further, that I.R.C. § 302(b)(1) applies only where the redemption "results in a meaningful reduction of the shareholder's proportionate interest in the corporation."

In the present case, [REDACTED] will still be considered to own [REDACTED] stock through attribution with its parent corporation and various subsidiaries and thus, the application of I.R.C. 302(b)(1) will not prevent dividend treatment of the redemption proceeds received in 1996.

*302(b)(2) (substantially disproportionate redemption of stock)*

Section 302(b)(2) provides exchange treatment for substantially disproportionate redemptions of stock. A distribution is substantially disproportionate if: (1) the shareholder's voting stock interest and common stock interest in the corporation immediately after the redemption are each less than 80 percent of those interests immediately before the redemption, and (2) the shareholder owns less than 50 percent of the voting power of all classes of stock immediately after the redemption. In the present I.R.C. § 302(b)(2) does not apply since [REDACTED], through the constructive ownership rules of I.R.C. § 318(a), is treated as owning all the stock of [REDACTED] both before and after the redemption.

*302(b)(3) (termination of shareholder's interest)*

One of the tests in section 302 for determining whether a distribution qualifies for exchange rather than dividend treatment is whether the

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<sup>3</sup>With the exception noted in fn. 2

distribution terminated the shareholder's interest in the corporation. Section 302(b)(3). It has long been recognized that such a termination may be achieved through a multistep transaction. E.g., Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954).

In Zenz, Fern Zenz owned all the shares of a corporation and desired to sell them. Because the buyer would not purchase all the shares, she sold some of the shares to the buyer and then had the corporation redeem the rest. The Commissioner argued that had the transaction been reversed, she would have in substance withdrawn earnings and profits through the "redemption," which would have been treated as a dividend distribution, and that therefore reversal of the steps should not affect that result. The court disagreed, reasoning that the distribution could not be essentially equivalent to a dividend because it was more akin to a liquidating distribution (which would be treated as an exchange) in that after the distribution she had no interest in the distributing corporation. The Service announced in Rev. Rul. 55-745, 1955-2 C.B. 223, that it would follow Zenz in similar fact situations.

Because the sale preceded the redemption, the court did not need to address whether the sale and redemption should be combined. However, the court reasoned since the intent of the taxpayer was to bring about a complete liquidation of her holdings and to become separated from all interest in the corporation, the conclusion was inevitable that the distribution of the earnings and profits by the corporation in payment for said stock was not made at such time and in such manner as to make the distribution and cancellation or redemption thereof essentially equivalent to the distribution of a taxable dividend.

The Service, in Rev. Rul. 75-447, 1975-2 C.B. 113, considered in, G.C.M. 35216 (Jan. 29, 1973), relying on Zenz and Rev. Rul. 55-745, concluded that in determining whether the requirements of I.R.C. § 302(b)(2) have been satisfied, the sequence in which a redemption and sale of stock occur is irrelevant so long as the events are clearly part of an overall, integrated plan to dispose of the stock outside of an affiliated group. See, Rev. Rul. 77-226, 1977-2 C.B. 90; Rev. Rul. 79-273, 1979-2 C.B. 125. See also United States v. Carey, 289 F.2d 531 (8th Cir. 1961).

Where redemptions were executed pursuant to a plan to terminate one's interest in a corporation, it has been held that dividend equivalency may be avoided where the individual redemptions are component parts of a single sale or exchange of an entire stock interest. In Re Lukens' Estate, 246 F.2d 403 (3<sup>rd</sup> Cir., 1957), rev'g 26 T.C. 900 (1956); Jackson Howell v. Commissioner, 26 T.C. 846 (1956), aff'd, 247 F.2d 156 (9<sup>th</sup> Cir., 1957). Similarly, where there is a plan comprised of several steps, one involving the redemption of stock that results in a complete termination of the taxpayer's interest in a corporation, section 302(b)(3) may apply. Leleux v. Commissioner, 54 T.C. 408 (1970); However, the redemption must occur as part of a plan which is firm and fixed and in which the steps are clearly integrated. Leleux at 418.

Thus the issue in this case is whether there was an integrated transaction to

terminate [REDACTED]'s interest in the [REDACTED]. If so, then the redemption will be treated as an exchange rather than a dividend. While [REDACTED] eventually sold its remaining interest (after the redemption), in [REDACTED], however it did so to its related entity [REDACTED], and thus did not terminate its interest in [REDACTED] since ownership attribution under I.R.C. § 318 applies. The exception in I.R.C. § 302(c)(2) (for not applying the section 318 attribution rules) would not apply since [REDACTED] retained an interest in [REDACTED] after the redemption and [REDACTED] stock still remains within the affiliated group. The capital loss generated from the subsequent sale to [REDACTED] is deferred under I.R.C. § 267(f)(2) until [REDACTED] is sold outside of the affiliated group.

*302(b)(4)( redemption from noncorporate shareholder in partial liquidation).*

Since [REDACTED] is a corporation, I.R.C. 302(b)(4) is inapplicable.

## II. Gain/Loss on the subsequent sale to [REDACTED]

As provided in I.R.C. § 1001, gain will be realized and recognized by [REDACTED] measured by the difference between the redemption price and [REDACTED]'s adjusted basis in the [REDACTED] stock being redeemed, as determined under section 1011.

In this case [REDACTED]'s original basis in the [REDACTED] stock (\$ [REDACTED]) was reduced by the return of capital in the amount of \$ [REDACTED] (the difference between the redemption proceeds and accumulated E&P). The basis shifted to the remaining shares under Treas. Reg. 1.302-2(c) was \$ [REDACTED]. The sale of the remaining shares to [REDACTED] triggered a deferred capital loss of \$ [REDACTED].

## III. Notice 2001-45

Notice 2001-45 described a transaction involving the redemption of stock purportedly owned by a foreign person in a transaction in which dividend treatment is claimed and the basis of the redeemed stock is purported to transfer to stock held by a U.S. taxpayer.

The notice described the typical fact pattern for the transaction as follows:

Taxpayer (TP) is a U.S. taxpayer with substantial capital gains. TP desires to shelter the gain from tax. After consultation with Promoter and/or Advisor, TP purchases a small number of shares of the stock of Foreign Bank (FB) on the open market. FB is a widely held, publicly-traded foreign bank that is not subject to U.S. tax. In addition, TP purchases from Foreign Corporation (FC) a warrant to acquire at least 50 percent of the outstanding stock of FC, a foreign corporation not subject to U.S. tax. The remaining issued and outstanding stock of FC is typically owned by Foreign Person (FP), a foreign person or persons also not subject to U.S. tax. The warrant also allows TP the option to put the warrant back to FC. Under this put option, TP may surrender or cash settle the warrant for a nominal amount based on a percentage of FC's net asset value.



FC borrows money from FB in approximately the amount of TP's capital gain. With the proceeds of that loan, FC purchases bearer shares of FB stock; the FB stock secures the loan. These bearer shares, however, remain in FB's possession. Settlement on the FB stock acquisition contract is set for a date at least 30 days in the future (Date1). At the same time FC enters into the contract to acquire FB stock, FC purchases a put option from FB, obtaining the right to sell its FB bearer shares if the price of its FB bearer shares falls below the initial purchase price and insulating FC from significant loss. The put is out of the money. In addition, FC sells FB a call option with a strike price reset feature, giving FB the right to purchase its bearer shares at a price below their initial purchase price and limiting FC's opportunity for significant gain. The call includes an integrated forward feature that, in the event of a change in the value of FB stock, may result in income or gain to FC. The call option is in the money.

On or about Date1, FB redeems the stock purportedly owned by FC. FB effects the redemption through the exercise of its call option. FC uses the redemption proceeds to repay the loan from FB. Simultaneously, TP purchases an option to acquire a number of FB bearer shares that is approximately equal to the number of FB shares that FC contracted to purchase. TP's option is deep out of the money and acquired at little cost.

TP then sells all or a significant portion of the FB stock. At some point before or after the stock sale, TP also surrenders the FC warrants. TP (or the partnership) either sells the FB options or allows them to lapse with a relatively insignificant amount of gain or loss. The series of transactions is generally accomplished within several months, but in all known cases, within one year.

Although the present case shares some similarities with the transaction described in Notice 2001-45, there are a number of significant differences which indicate this case is not of the type of transaction involving the basis shifting tax shelter.

First, the [REDACTED] transaction does not involve a gain sheltering transaction which is the principal purpose of the basis shifting tax shelter. As noted above, [REDACTED] is not in a position to recognize any capital loss from the [REDACTED] redemption, nor is there any indication that [REDACTED] had any capital gain in need of sheltering during the years at issue.

Additionally, one of the primary arguments used to address the basis shifting tax shelter, actual ownership of the redeemed shares, is not at issue in this case. The notice asserts that ownership of the redeemed shares in the basis shifting tax shelter should be disregarded since the use of the put and call options (e.g. a collar transaction) eliminates the burdens and benefits of stock ownership and in fact makes the re-acquisition of the stock (via the redemption) a virtual certainty. In the present case [REDACTED] owned the shares of [REDACTED] long before the redemption and without the use of any put or call options.

The Notice also recognizes the potential application of the Zenz doctrine to deny dividend treatment for the redemption in cases involving a partial redemption of stock

followed by a sale of the remaining stock to an unrelated party. As discussed above, [REDACTED]'s sale of the remaining shares of [REDACTED] was not to an unrelated party, was not part of an integrated plan and to date, the stock has not been sold outside of the control group.

The Notice argues that the basis shifting from the redeemed share to the remaining shares may not be a proper adjustment under Treas. Reg. Sec. 1.302-2(c) since the dividend distribution was not recognized by the redeeming party. In the present case [REDACTED] recognized dividend income to the extent of [REDACTED]'s E&P.

The Notice cites ACM Partnership v. Commissioner 157 F.3d 231 (3d Cir. 1998) as a basis for describing the basis shifting tax shelter as a "series of contrived steps that effect an artificial loss on TP's disposition of FB stock. The stock loss is not bona fide and does not reflect actual economic loss." In the present case there is no indication that the objective of the [REDACTED] redemption was to generate any capital loss and in fact has yet been claimed by the taxpayer in the more than five years since the transaction. Also, the taxpayer's stated business purpose of applying the redemption proceeds to increase [REDACTED]'s North American Operations has been validated through a number of significant North American acquisitions since the date of the redemption.

In light of the observations above, the redemption issue described in this advice is not the same as or substantially similar to the "basis shifting tax shelter" described in Notice 2001-45. This issue has been coordinated with Earnest Griffin, Issue Specialist, Tom Kerrigan, Industry Counsel, and Lisa Leong, CC:CORP:4.

If you have any further questions concerning this matter, please feel free to telephone the undersigned at (313) 237-6426. This advice is subject to National Office Review and should not be relied upon or disseminated for a period of 10 days or upon notification of this office. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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enclosure  
As stated